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RR RUEHAG RUEHDF RUEHIK RUEHLZ
DE RUEHMD #2525/01 2790718
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R 060718Z OCT 06
FM AMEMBASSY MADRID
TO RUEHC/SECSTATE WASHDC 0951
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE
RUEHLA/AMCONSUL BARCELONA 2122
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC

UNCLAS SECTION 01 OF 05 MADRID 002525

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DEPARTMENT FOR EUR/WE

E.O. 12958: N/A
TAGS: ECON SP
SUBJECT: SPAIN: GALICIA'S ECONOMY TRANSFORMED BY 20 YEARS
OF EU FUNDING

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SUMMARY AND INTRODUCTION

¶1. Spain's 1986 entry into the European Union turned on a tap of EU funding which has helped transform the face of modern Spain. To gain a better understanding of the impact of European funding on Spain's 16 regions, Embassy Madrid's Economic section plans to visit many of these regions over the next year and prepare a series of baseline cables on Spain's regional economies. We begin this series with this report on the Galician economy. ECONOFF visited Galicia September 25-26, meeting with the regional ministers of economy and education/science, the Director of Caixa Novo (southern Galicia's largest savings and loan bank), several officials of Caixa Galicia (northern Galicia's largest savings and loan bank), 15 businessmen from Vigo representing the most significant sectors of the Galician economy, the Director of Galicia's largest business federation, and two economist/university professors.

¶2. Twenty years of EU funding has been good for Galicia. Infrastructure has been modernized; isolation from the rest of Spain has ended; the negative impact of the decline of certain key economic sectors has been cushioned; and the rise of new economic sectors has been facilitated. Galicia has been transformed and is no longer the isolated backwater most famous of sending immigrants to the Americas. The public face of Galicia now resembles that of the rest of Spain. But true economic "convergence" (i.e., making Galicia as rich as the rest of Spain) has not been achieved. Galicia's GDP in 1986 lagged well behind that of Spain. In 2006, Galicia still lags behind. Less behind than 20 years ago, but still further enough back to continue to qualify for EU convergence funding through the end of the EU's 2013 budget cycle. But the chip on Galicia's collective shoulder vis-a-vis the rest of Spain has been removed with the help of 20 years of EU subsidies and today Galicians are both confidant about their economic future and proud to be Galician, Spanish and European. END SUMMARY AND INTRODUCTION

A GALICIA PRIMER

¶3. Galicia occupies 29,639 square kilometers in the northwest corner of Spain, above Portugal and to the west of the Asturias and Castilla and Leon regions. Its territory encompasses 5.8 percent of Spain. It is one of the westernmost points in continental Europe, enjoying relatively

close proximity to American markets and sitting astride important sea lanes of communication. Galicia has 1,300 kilometers of coastline along the Atlantic Ocean and forests cover 69 percent of its territory. Galicia contains 2,762,000 inhabitants, which represents just under six percent of the total Spanish population. Galicia's capital and administrative center is the inland city of Santiago de Compostela (92,000 inhabitants). Its other major population centers include Vigo (293,000 inhabitants), La Coruna (244,000 inhabitants), and Ourense (109,000 inhabitants).

¶4. Galicia is as one of Spain's historic autonomous communities, along with Catalonia and the Basque Region. The official languages of Galicia are Spanish and Gallego, which is similar to Portuguese. Galicia enjoys close geographic and cultural ties to northern Portugal and until the advent of EU funded infrastructure development, Galicia enjoyed better communication links with the Porto region of Portugal than it did with the rest of Spain.

ECONOMIC SNAPSHOT

¶5. Galicia's 2005 GDP was 47.9 billion euros, which represents roughly 5.4 percent of Spain's GDP. Galicia's GDP grew by 3.3 percent in 2005, while Spain as a whole grew by 3.5 percent. Galician imports totaled 13.6 billion euros in 2005, while exports totaled 12.1 billion euros. Over seven billion of the 13.6 billion in imports came from the EU25, with France in the lead as the source of 2.6 billion euros in Galician imports, followed by Portugal with 1.6 billion euros in Galician imports. Only 321 million euros of Galician imports came from the U.S. As a result, the U.S. was only the 8th largest supplier of Galician imports, trailing five EU member states, Mexico (463 million euros) and China (395 million euros). Of the 12.1 million euros of Galician

exports registered in 2005, 8.8 billion euros worth went to EU25 nations, with France (3.9 billion euros) and Portugal (2 billion euros) representing the largest EU25 importers of Galician products. The U.S. imported 222 million euros in Galician products in 2005, which made the U.S. the seventh largest importer of Galician products, following six EU25 members.

¶6. Regarding the nature of the 13.6 billion euros of Galician imports in 2005, leading import products included automobiles or automobile parts (2.9 billion euros), coal (2 billion euros), maritime navigation equipment (1.5 billion euros), milk products (1.4 billion euros), steel (707 million euros), clothing pieces (589 million euros), and pharmaceutical products (390 million euros). As for the nature of the 12.1 billion euros of Galician exports in 2005, leading export products included automobiles or automobile parts (4.1 billion euros), finished clothes or clothing pieces (1.5 billion euros), maritime navigation equipment (1.3 billion euros), fish and fish products (853 million euros), wood and cellulose products (530 million euros), coal (478 million euros), machinery (462 million euros), cement (315 million euros), and prepared meat or fish products (304 million).

¶7. Galician origin foreign investment totaled 694 million euros in 2005, of which 397 million was destined for EU25 nations. Leading destinations of Galician investment included Italy (112 million euros), France (96 million euros), Mexico (82 million euros), Portugal (73 million euros), the United Kingdom (68 million euros). Galician origin investment in the U.S. in 2005 totaled 45 million euros. Foreign investment in Galicia totaled 190 million in
¶2005. Leading foreign investors included Portugal (126 million euros), the U.S. (15 million euros), and the Netherlands (13 million euros). Most foreign investment in 2005 was directed to the financial services sector (115

million of the 190 million total). Given the low overall rate of foreign investment, it is clear that an individual deal (e.g., a Portuguese financial institution buying a counterpart in Galicia) could skew the statistics in any given year.

¶8. Total employment in Galicia has hovered between 1,000,000 and 1,100,000 during the last 20 years, but the sectors employing these million workers have changed remarkably. In 1986, over 400,000 Gallegos (over 40 percent of total employed workers) were employed in the agriculture and fishing sectors. Today, the number working in those sectors has declined to 115,000. Rural small hold agricultural workers specializing in milk and beef production bore the brunt of this decline. Galician agriculture, which was based in small, atomized land parcels, proved unable to survive in the larger common agricultural market. More than one interlocutor told ECONOFF that "French milk devastated Galicia's agricultural sector." During that same 20 year period, those working in the service sector increased from 400,000 to 600,000, while those employed in industry grew from 140,000 to 194,000, and those employed in the construction sector grew from 75,000 to 127,000. 146,000 Galician workers were unemployed as of August 2006 and the Galician unemployment rate (9.9 percent as of August 2006) has generally run significantly above that of the rest of Spain. The Galician inflation rate has generally tracked that of Spain.

KEY ECONOMIC SECTORS

¶9. Perhaps most important sectors of the Galician economy are automobiles and automotive parts, fishing and fish processing, and textiles. Other key sectors include wood and paper products, agricultural products (produced by large scale producers which emerged following the death of the family farm), granite and other non-metals mining, small and medium naval construction, biotechnology, construction/property, wind and hydro electricity production, pharmaceuticals/chemicals, telecommunications/audiovisual products, tourism, mechanical equipment, and rubber and plastics. According to the Galician Minister of the Economy, there are only 59 businesses in the region that employ more than 500 workers. Of Galicia's 173,000 businesses, roughly 102,000 employ no/no salaried workers, 71,000 employ between 1 and 49 salaried workers, and 1,200 employ between 50 and 499 salaried workers.

GALICIA'S EU EXPERIENCE

¶10. The entry into the Common Market led to the serious decline of certain sectors of the Galician economy such as traditional small scale agriculture/fishing and large naval construction (e.g., the virtual collapse of the Ferrol shipyards outside La Coruna), while opening markets for other sectors like automobiles and auto parts and textiles, and forcing other sectors to modernize in order to grow (e.g., fishing and fish processing). Automobile and automotive parts production greatly expanded in importance after the French corporation Peugeot opened a large plant in Vigo and this plant served as a pole of attraction for other smaller firms supplying it. Textiles also grew in importance with the rise of the Inditex corporation outside La Coruna. Inditex is now Europe's largest clothing retailer (having recently passed the Swedish Hennes and Mauritz chain). Based in Arteixo, outside la Coruna, it has 2,800 stores worldwide. It opened over 500 stores in the past year and plans to have 4,000 stores open the end of 2009. Key brands include Zara, Massimo Dutti and Bershka. Half of its market is in Spain, while the rest is abroad, principally in Portugal and France.

Vigo-based Pescanova is a global fishing and fish processing powerhouse. Spain remains Europe's leading fishing nation. Galicia leads all other Spanish regions in fishing and Pescanova leads the sector in Galicia.

¶11. EU funding allowed Galicia to greatly modernize its infrastructure, helping to finance highways, international airports in Vigo, Santiago de Compostela and La Coruna, several modern port facilities, and numerous high speed rail links. Galicia went from having 100 kilometers of highways in 1986 to over 800 kilometers in 2005. When Galicia joined the EU, traveling by road from La Coruna to Madrid took between 14 and 18 hours; today it takes less than six hours. Three high quality universities were also subsidized, allowing university enrollment to increase from under 40,000 in 1985 to close to 80,000 in 2006.

¶12. According to Galicia's Economy Minister, from 1989 through 2006, EU structural adjustment (or convergence) funding to Galicia totaled just over 9 billion euros (which represented just under 14 percent of total EU convergence funding provided to Spain). One economist/university professor told ECONOFF that this 9 billion euros represented between 2.0 and 2.3 percent of Galicia's GDP between 1994-2006. EU convergence funding for Galicia in the 2006-2013 EU budget cycle is expected to top 3.5 billion euros. Given Galicia's development, the impact of this funding will be somewhat less than in earlier periods (under 2.0 percent of total Galician GDP).

¶13. According to the Galicia's Economy Minister, roughly 70 percent of the EU funding received from 1989 through 2006 paid for what he referred to as Public Capital Formation, while about 30 percent paid for Private Capital Formation. The largest line item in Private Capital Formation was efforts to improve private sector production and the access to markets of private sector products. The largest line item in Public Capital Formation was infrastructure works, which accounted for 41 percent of total EU funding from 1989-2006. The Economy Minister also stressed the dramatic opening of Galicia's market during the 20 years of EU membership, noting that exports as a percentage of GDP increased from 10 percent to 25 percent between 1989 and 2005. The economist/university professor had a slightly different take on how the 9 billion euros has been spent. He said that 37 percent was spent on efforts to ensure the competitiveness of Galicia's economic base (e.g., mostly the transformation of agricultural and fishing sectors), while 32 percent was spent on infrastructure (roads, ports and high speed rail links), 15 percent on health and environmental projects (e.g., hospitals and water treatment facilities), 13 percent on human resources and employment-related projects (e.g., building human capital via better education, university subsidies, etc.), and 3.0 percent on miscellaneous development projects.

BUT CONVERGENCE NOT ACHIEVED

¶14. In 2005, average GDP per person in Spain was 20,838 euros. In Galicia it was 16,860 euros. Spanish GDP growth averaged 3.4 percent per year between 1995 and 2004, while

Galicia's economy grew at an average annual rate of 2.8 percent during that same period. In terms of purchasing power parity, Galicia's economy grew at an annual rate of 2.23 percent between 1995-2004, while the rate for Spain as a whole was 2.42 percent and the rate for the EU 25 was 1.83 percent. In terms of convergence, in 1995, Spanish GDP per person was at 87.5 percent of the EU15 average, while Galicia was at 71.3 percent of that average. In 2003, Spain was up to 97.3 percent of the EU25 average, while Galicia lagged behind at 76.6 percent of the EU25 average. As a result, Galicia, along with Extremadura, Andalucia and Castilla la

Mancha will continue to access EU convergence funding through the end of the 2013 EU budget cycle. Galicia's Minister of Economy told ECONOFF that overcoming this lack of convergence was his principal economic goal.

EU FUNDING PROCESS IMPOSES DISCIPLINE

¶15. Several of ECONOFF's interlocutors in Galicia stressed the role EU funding played in "forcing" Galicia and Spain as a whole to modernize and professionalize its central and regional administrations. EU funding was not direct transfers to central or regional administrations and was instead contingent on Galicia and Spain complying with certain EU regulations. Rather than losing some of the "free money," (like many recent adherents to the EU), Galicia and Spain took the decision to modernize and professionalize its administrations to guarantee the EU funding flow. Compliance with EU regulations also "forced" Galicia and Spain to forge a political consensus on integrated and long-term regional development plans, which in turn helped to ensure that the funding was spent in a rational fashion. One of ECONOFF's interlocutors estimated that Galicia had spent 85 percent of its EU funding in a wise fashion. Asked about "white elephants," he could only point to: (1) the fact that modern international airports were constructed with EU funds in Vigo, La Coruna and Santiago de Compostela, when one major airport located between the three cities would have sufficed, and, (2) the fact that modern international ports were constructed with EU funding in La Coruna and Ferrol, even though the two cities are only 15 kilometers apart. Individually, they represent Spain's 8th and 11th largest ports. If one combined port had been constructed, it would have been Spain's 4th largest port.

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FOCUS ON R&D SPENDING TO HELP ACHIEVE CONVERGENCE
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¶16. Galicia's Economy Minister told ECONOFF that relatively low levels of spending on R&D has been a leading cause of Galicia's and Spain's relatively weak productivity growth. In 2003, the EU15 spent an average just under two percent of GDP on R&D, while Spain spent just over one percent and Galicia a mere 0.8 percent. The Economy Minister said stepped up spending on R&D to achieve a better productivity growth rate was key to his plan to achieve convergence with Spain. As part of this strategy, Galicia and the Spanish national Ministry of Education and Science signed an accord in September to provide national assistance to Galicia's plans to develop four "technopoles" throughout the region.

COMMENT

¶17. Twenty years of EU funding has been good for Galicia. Infrastructure has been modernized; isolation from the rest of Spain has ended; the negative impact of the decline of certain key economic sectors has been cushioned; and the rise of new economic sectors has been facilitated. Galicia has been transformed and is no longer the isolated backwater most famous of sending immigrants to the Americas. The public face of Galicia now resembles that of the rest of Spain. But true economic "convergence" (i.e., making Galicia as rich as the rest of Spain) has not been achieved. Galicia's GDP in 1986 lagged well behind that of Spain. In 2006, Galicia still lags behind. Less behind than 20 years ago, but still further enough back to continue to qualify for EU convergence funding through the end of the EU's 2013 budget cycle. But the chip on Galicia's collective shoulder vis-a-vis the rest of Spain has been removed with the help of 20 years of EU subsidies and today Galicians are both confidant about the economic future and proud to be Galician, Spanish and

Europeans.

AGUIRRE